No. 15,046

# United States Court of Appeals

## For the Ninth Circuit

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Wells Fargo Bank & Union Trust Co., Executor of the Will of Walter D. K. Gibson, Deceased,

*Appellant,*

vs.

United States of America,

*Appellee.*

## APPELLANT'S REPLY BRIEF.

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W. T. Fitzgerald,
Clarence E. Musto,
Franklin C. Latcham,
Morrison, Foerster, Holloway,
Shuman & Clark,
Crocker Building, San Francisco 4, California,
*Attorneys for Appellant.*



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## APPELLANT'S REPLY BRIEF.

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### I.

### ONLY ONE-HALF THE INCOME IS TAXABLE TO WALTER'S ESTATE UNDER THE DECISION IN BISHOP v. COMMISSIONER.

Although appellant reaffirms its contention that the lack of mutality of obligation prevents the waiver executed by decedent's wife from being a binding contract (App. Br. 13-15), nevertheless appellant submits that, even if the Court should hold the waiver to be a contract binding upon decedent's wife, appellant is still entitled to prevail in this action for the following reasons.

Appellee argues that upon decedent's death the waiver and the will, taken together, constitute a binding contract

upon decedent's wife (see Gov't. Br. 14, 15, and *Estate of Whitney,* 171 Cal. 750, 154 Pac. 855 (1916), cited App. Br. 13). Appellee also argues, however, that the result of this contract is that decedent's wife took merely as a beneficiary under decedent's will. It is apparent that the contract must be enforceable in favor of the wife as well as against her, and that she therefore received her benefits under the will by reason of the contract and not as a gratuitous beneficiary. Under the terms of that contract decedent's wife had the right to withdraw one-half the estate. This is the same right she would have had if she had retained her community property interest. Of course, she could only receive actual possession of the property upon a partial or final distribution of the estate, but a wife can only receive physical possession of her share of the community property upon a partial or final distribution of the estate. (Section 202, California Probate Code, discussed Appellant's Brief, 10-13.)

Thus the contract right of decedent's wife to withdraw half the estate and the legal right of a surviving widow to one-half the community property are identical and should receive the same treatment under the Internal Revenue Code for income tax purposes.

Appellee apparently misconceives appellant's position in regard to *Pacific National Bank of Seattle, Executor,* 40 B.T.A. 128 (1939), acq. 1939-2 C.B. 28, and *Coffman-Dobson Bank & Trust Co.,* 20 B.T.A. 890 (1930), acq. X-1 C.B. 13 (1931) (Gov't. Br. 14, footnote 4). Appellant recognizes that those cases deal with the federal estate tax and not with the federal income tax, but that is not important here. What is important is the discussion in the

cases in regard to the community property law governing the effect of the wife's waiver of her community property rights. In both cases the deceased husband had created a testamentary trust. The cases conclude that under the community property law the wife's waiver is to be construed as if she contributed her one-half of the community property which she owned at the date of the husband's death to the testamentary trust created by the husband. That is, the wife is in effect a grantor as to one-half the property in the testamentary trust. That general legal analysis of the effect of the wife's waiver of her community property interest is as valid for the application of the federal income tax as it is for the application of the federal estate tax. Thus under the analysis of these cases the wife is the grantor of one-half the property included in the testamentary trust created by the husband's will. If she has the right to withdraw one-half of that property, the applicability of section 166 of the Internal Revenue Code of 1939 is easily seen (see discussion App. Br. 15-21).

It should be noted that under section 166 (quoted App. Br. 17) income of the trust is taxable to the grantor, "Where *at any time* the power to revest title * * * is in the grantor." (Italics supplied.) The Commissioner interpreted section 166 to mean that the income of the trust is taxable to the grantor, "If the title to the corpus will revert in the grantor upon the exercise of such power * * * regardless of—

* * *

> "(iii) The time at which the title to the corpus will revert in the grantor in possession and enjoyment, whether such time is within the taxable year or not, or whether such time be fixed, determinable, or certain

to come.'' (U.S. Treas. Reg. 118, section 39.166-1(b).)

Thus the fact that decedent's wife would have to wait a few months until distribution of the estate would not prevent one-half of the income from the estate from being taxed to her under section 166. Of course, under *Bishop v. Commissioner,* 152 F.2d 389 (9th Cir., 1945), the fact that the wife has to wait until her share of the community property is distributed to her does not prevent one-half of the income from the property subject to administration in the husband's estate from being taxed to the wife.

Appellee cites sections 158 and 159 of the California Civil Code under which the spouses may by contract change the character of their property from community to separate, and cases from this Court holding that such a change must be recognized for federal income tax purposes:

*O'Bryan v. Commissioner,* 148 F.2d 456 (9th Cir., 1945);

*Van Dyke v. Commissioner,* 120 F.2d 945 (9th Cir., 1941);

*Boland v. Commissioner,* 118 F.2d 622 (9th Cir., 1941);

*Sparkman v. Commissioner,* 112 F.2d 774 (9th Cir., 1940);

*Helvering v. Hickman,* 70 F.2d 985 (9th Cir., 1934).

These basic rules of law are, of course, well recognized if we grant that a binding contract was made. Assuming that a binding contract was made, it is necessary to carry these basic rules one step farther in order to decide the case at bar. In the cited cases the Court carefully con-

strued the agreements between the parties in order to determine the nature of the parties' rights. In none of those cases did the agreement involve a transfer of a community interest with a right to withdraw the value of the property transferred.

Appellant submits that if the Court holds that the waiver and will constitute a binding contract, the power of decedent's wife under that agreement to withdraw one-half of the estate requires that one-half of the income received by the estate be taxed to decedent's wife. The wife's power of control is the big factor in this case, as this Court in the *Bishop* case held. Even if the power to withdraw one-half of this testamentary trust did not originate in the decedent's wife by contract, that is, even if it was donated by decedent to her, still the Commissioner has argued and the courts have held that a person holding such a donated power is taxable on the income from trust property over which the person has such power. *Emery v. Commissioner,* 156 F.2d 728 (1st Cir., 1946), cert. den. 329 U.S. 772 (1946); *Mallinckrodt v. Nunan,* 146 F.2d 1 (8th Cir., 1945), cert. den. 324 U.S. 871 (1945). If a person with a donated power is subject to tax, certainly decedent's wife, with a contract right to withdraw one-half of the testamentary trust, is subject to tax.

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## II.

### THE DEFENSE OF EQUITABLE RECOUPMENT.

Appellant in its opening brief demonstrated: (1) that the doctrine of equitable recoupment has a narrow scope; (2) that the Commissioner's laches prevents the applica-

tion of the doctrine in this case; (3) that the lack of identity of the parties prevents the application of the doctrine in this case; and (4) that Internal Revenue Code procedures supersede the doctrine. Appellant desires to make a few comments under each of these headings in reply to appellee's brief.

**A. The Narrow Scope of the Doctrine of Equitable Recoupment.**

Appellee states that it does not "read *McEachern v. Rose,* 302 U.S. 56, relied on by taxpayer (Br. 24), as overruling or limiting the principles laid down in *Stone v. White*" (Gov't. Br. 23). As appellant pointed out in its opening brief, however, the Supreme Court in *McEachern v. Rose, supra, Rothensies v. Electric Storage Battery Co.,* 329 U.S. 296 (1946), and *Commissioner v. Gooch Milling & Elevator Co.,* 320 U.S. 418 (1943), has severely limited the doctrine of equitable recoupment (App. Br. 24, 25). In commenting on the cases of *Bull v. United States,* 295 U.S. 247 (1935) and *Stone v. White,* 301 U.S. 532 (1937) (discussed App. Br. 22-24), the Supreme Court in *Rothensies v. Electric Storage Battery Co., supra,* stated:

> "The application of this general principle to concrete cases in both of the cited decisions is instructive as to the limited scope given to recoupment in tax litigation. * * * Whatever may have been said indicating a broader scope to the doctrine of recoupment, these facts are the only ones in which it has been applied by this court in tax cases." (329 U.S. 296 at pp. 299, 300).

Appellant has quoted the statement of Judge Frank of the Second Circuit in regard to the limiting effect of the later Supreme Court cases in *Wood v. United States,* 213 F.2d 660 (1954) (App. Br. 25). Appellant has not argued

that the later Supreme Court cases overruled *Stone v. White, supra,* but only that the later cases had limited the application of the doctrine of equitable recoupment to the peculiar facts in that case. Appellant submits that the cases amply support its position.

**B. The Commissioner's Laches Prevents Application of the Doctrine.**

Appellee's brief does not discuss the issue of the Commissioner's laches as a factor in preventing the application of the doctrine of equitable recoupment. Appellant submits, however, that the Commissioner's failure to act in a timely fashion to collect the erroneous refund paid to Emily A. Gibson, deceased, forecloses appellee's reliance upon the equitable recoupment doctrine. As pointed out on pages 26 and 27 of appellant's opening brief, Emily A. Gibson, deceased, received a tax refund on July 11, 1945. Under section 3746(b), Internal Revenue Code of 1939, the Commissioner had two years, or until July 11, 1947, within which to collect this erroneous refund. The *Bishop* case was decided on December 10, 1945. No application for certiorari was made by the Commissioner, and therefore it represents a final decision. The Commissioner had approximately eighteen months after the *Bishop* decision to collect the erroneous refund paid to Emily A. Gibson, deceased. However, he failed to take any steps to collect the refund or to protect himself against the bar of the statute of limitations.

It must be recalled that on June 30, 1947, Walter's Estate filed a claim for refund of the additional tax paid because of the Commissioner's inclusion in Walter's Estate of one-half of the income for the period from Jan-

uary 1, 1941, to August 26, 1941, originally reported by Emily A. Gibson, deceased (R. 9, 10, 23, Stip., par. 13). On April 8, 1948, the Internal Revenue Agent in Charge at San Francisco advised Walter's Estate of a report by a representative of that office recommending that the overassessment be allowed (R. 23, Stip., par. 14). That report recommended that the overassessment be allowed on the basis of *Bishop v. Commissioner, supra* (Stip., Ex. 7, page 5). Walter's Estate received a certificate of overassessment on April 12, 1950, certifying that its income tax for 1941 had been overassessed by $9,362.58. This certificate was also based upon the *Bishop* case. However, the overassessment was reduced by the sum of $7,100.35, the amount of the proposed deficiency in tax due from Emily A. Gibson, deceased (R. 24, par. 15).

Thus the Commissioner had taken the position that the *Bishop* case applied to the present proceeding and that Walter's Estate was entitled to a refund, but that because the statute of limitations had run against Emily A. Gibson, deceased, the Commissioner was entitled to withhold the deficiency due from her or her transferees.

Appellant respectfully submits that the whole problem in this case arises because the Commissioner failed to act in a timely fashion to collect the refund erroneously paid to Emily A. Gibson, deceased, or to protect the Government against the bar of the statute of limitations within the eighteen-month period available to him after the decision in the *Bishop* case. Instead of acting in a timely fashion the Commissioner asserted a right to recoup money due from Emily A. Gibson, deceased, by withholding it from a refund legally due Walter's Estate.

The Court of Claims has refused to allow the Government to assert the doctrine of equitable recoupment in cases where the Commissioner has not acted equitably, that is, has failed to assert his rights in a timely fashion.

> *McNaghten v. United States,* 17 F. Supp. 509 (Ct. Cl., 1937);
>
> *Benfield v. United States,* 27 F. Supp. 56 (Ct. Cl., 1939).

The Government did not seek certiorari to the Supreme Court in either of these cases.

See also *Wood v. United States, supra;*

> *United States v. S. F. Scott & Sons, Inc.,* 69 F.2d 728 (1st Cir., 1934).

The preceding cases are discussed in appellant's opening brief, pages 26-30.

Appellant submits that the Government cannot now rely on an equitable doctrine to overcome the bar of the statute of limitations when it has failed to act in an equitable manner to protect its rights before those rights were terminated by the statute of limitations.[1]

**C. Lack of Identity of the Parties Prevents Application of the Doctrine.**

It is clear from the cases that, unless there is a clear identity of the parties as between those who will receive the refund and those who are liable for the deficiency, the doctrine of equitable recoupment will not apply. The cases have not applied the doctrine of equitable recoupment

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[1]As noted, however, in subheading "D", *infra,* the Internal Revenue Code provides a procedure for appellee to assert its rights against Emily A. Gibson, deceased, if judgment is awarded to appellant in the case at bar.

where the parties who are liable for the deficiency would not directly participate in the receipt of the refund (see cases discussed App. Br. 30-36).

In the present case one-half of a judgment in favor of appellant would go to the trust administered by the Crocker First National Bank of San Francisco (now the Crocker-Anglo National Bank) under the trust created by decedent's wife in which Grace Collins and Walter D. K. Gibson, Jr. are the life income beneficiaries; one-fourth would go to the Wells Fargo Bank as trustee of the trust created in decedent's will, Grace Collins being the life income beneficiary; one-eighth would go outright to Walter D. K. Gibson, Jr.; and one-eighth would go in trust to Joanne Gibson (R. 33, Supplemental Stip. par. 2).

Walter D. K. Gibson, Jr. and Grace Collins are equal residuary legatees of Emily's Estate, but they are not the only beneficiaries of Emily's Estate (R. 26, Stip., par. 20).

Appellee assumes that Walter D. K. Gibson, Jr. and Grace Collins are the only beneficiaries of Emily's Estate and, therefore, that they alone would be liable as transferees of her estate for any deficiency in tax owing by Emily A. Gibson, deceased. (Gov't. Br. 20, 21.) But there is another beneficiary or beneficiaries of Emily's Estate who would also be liable as a transferee or transferees. Under paragraph 20 of the stipulation of facts (R. 26) Emily's Estate had total assets of \$75,076.26 and total disbursements other than the payment of legacies of \$52,141.26.[2] The difference between \$75,076.26 and

[2]Due to an error in the stipulation of facts total disbursements other than the payment of legacies is stated to be \$39,141.14. That figure should read \$52,141.26.

$52,141.26 is $22,935.00. Walter D. K. Gibson, Jr. and Grace Collins each received cash and assets valued at $9,717.50, or a total of $19,435.00. The difference between $22,935.00 and $19,435.00 is $3,500.00. Thus some other beneficiary or beneficiaries received a bequest or bequests from Emily's Estate totalling $3,500.00.

Therefore, there is a beneficiary or beneficiaries in addition to Walter D. K. Gibson, Jr. and Grace Collins who would be liable as a transferee or transferees. Under section 311(a) of the Internal Revenue Code of 1939 the liability of a transferee of property from a taxpayer is stated to be:

> "(1) Transferees.—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed on the taxpayer by this chapter."

The term "transferee" is defined in section 311(f): "As used in this section, the term 'transferee' includes heir, legatee, devisee and distributee." These provisions are carried over in substantially the same form in section 6901, Internal Revenue Code of 1954.

Thus there is no doubt that any legatee or distributee from a decedent's estate qualifies as a "transferee" under the above Code provisions.

See,

*Parker v. Commissioner,* 122 F.2d 230 (9th Cir., 1941);

*Tooley v. Commissioner,* 121 F.2d 350 (9th Cir., 1941).

Furthermore the liability of transferees of property from a taxpayer under the above provisions is joint and several to the extent of the property received.

*Estate of Robert Lewis Harrison*, 16 T.C. 727 (1951).

Appellee has asserted the doctrine of equitable recoupment as an affirmative defense. The burden is therefore on appellee to introduce sufficient evidence to sustain that defense, that is, evidence showing an identity between the parties who would benefit from the judgment prayed for by appellant and who would be liable as transferees for any deficiency in tax owing by Emily A. Gibson, deceased. The facts in this case, however, fail to show such an identity of parties. The transferees from Emily's Estate are shown to be Walter D. K. Gibson, Jr., Grace Collins, and another beneficiary or beneficiaries. On the other hand, only in the case of the one-eighth share which would go directly to Walter D. K. Gibson, Jr., can it be said definitely that any part of a judgment for appellant would go to transferees of Emily's Estate.

In *Stone v. White, supra,* the facts showed that by the terms of the trust any recovery of an overassessment by the trustee would be paid directly to the income beneficiary. In the case at bar it is stipulated that if the judgment prayed for by appellant is granted the recovery will be paid to the trusts involved, not the income beneficiaries, Walter D. K. Gibson, Jr., and Grace Collins. Thus, on this ground alone *Stone v. White* is clearly distinguishable from the present case.

Appellee attempts to show, however, that Walter D. K. Gibson, Jr., and Grace Collins will receive the corpus of

the trusts by reciting certain powers of invasion of the corpus and certain special powers of appointment.

Under the trust created by Emily A. Gibson the trustee has the power in its sole discretion to pay amounts from the corpus necessary for the care, maintenance and support of the income beneficiary if in the trustee's opinion the income is insufficient for the proper support, maintenance and care of the beneficiary. Such amounts may not exceed $5,000 per year (R. 33-35). Grace Collins has had a right since reaching the age of fifty-five (June 16, 1949) to withdraw $10,000 a year from the corpus, which right is cumulative. Walter D. K. Gibson, Jr., will have that right when he reaches the age of fifty-five on June 16, 1958.

Under the trust created by decedent in which the Wells Fargo Bank is trustee, Grace Collins has the power to invade corpus to the amount of $5,000 per year, which right is cumulative. Also, Grace Collins will receive the corpus if she should become a widow.

Appellee has not adduced any evidence to show that the corpus of either of these trusts has ever been invaded, or that the corpus is likely to be invaded in the future. Nor has the appellee introduced any evidence to show the actuarial value of the powers of withdrawal held by the income beneficiaries. The Government has the burden of proof on this equitable defense, but it has adduced no evidence to show that these income beneficiaries will ever receive any part of the corpus of these trusts.

The Government points to the fact that under the trust created by Emily A. Gibson, the income beneficiaries have special testamentary powers to appoint the corpus. How-

ever, these special powers merely give the income beneficiaries the right to appoint the corpus to specified members of their families, powers of appointment which Congress has stated are not sufficiently broad to make them taxable under the federal estate tax. (See section 2041, Internal Revenue Code of 1954.) It can hardly be argued that such limited powers are the equivalent of the right to receive the corpus of these trusts.

Furthermore, even if appellee had proved that part of the corpus of these trusts would be received by Walter D. K. Gibson, Jr., and Grace Collins, appellee has not sustained its burden of proving an identity of the parties because it has not shown that the other beneficiary or beneficiaries of Emily's Estate will participate in any judgment for appellant.

Appellee, at page 23 of its brief, comments upon some of the lower court's cases relied upon by appellant to demonstrate the inapplicability of *Stone v. White* to the facts in this case because of the lack of identity of the parties. Appellee notes that in *Benfield v. United States, supra,* there was a lack of substantial identity of the parties. Appellant agrees with appellee, but, as appellant pointed out in its opening brief at pages 32 and 33, the facts of the *Benfield* case are very close to those of the present case.

Appellee failed to comment on Judge Learned Hand's opinion in *Schlemmer v. United States,* 94 F.2d 77 (2nd Cir., 1938), discussed in appellant's opening brief, pages 33-35. Appellant submits that this decision is a forceful authority in its favor on the issue of lack of identity of the parties.

Appellee does not believe that *Sewell v. United States,* 19 F.Supp. 657 (Ct.Cl., 1937) is helpful to appellant. Appellant cited the *Sewell* case, however, to emphasize that equitable recoupment will not be applied where the refund will go to the corpus of the trust and will not be directly received by the income beneficiary who would otherwise be liable for the deficiency.

**D. Internal Revenue Code Procedures Supersede Equitable Recoupment.**

In its brief appellee states:

> "It is true that should the Court render judgment in favor of the taxpayer in this case, that judgment will operate to lift the bar against assessment of the tax against the Estate of Emily Gibson or its transferees in accordance with Sections 1311 through 1315 of the Internal Revenue Code of 1954 (26 U.S.C. 1952 ed., Supp. II, Secs. 1311-1315)." (Gov't. Br. 24.)

Appellee thus admits that the Internal Revenue Code offers a procedure for the proper recovery of the erroneous refund made to Emily A. Gibson, deceased. It is submitted that the Government must follow the well recognized rule in equity that remedies at law must be exhausted before equitable remedies may be pursued. Since the Government has an adequate remedy at law for the recovery of the refund erroneously made to Emily A. Gibson, deceased, it has no equitable right to withhold that refund from appellant. Particularly is this true where appellee is relying on an equitable doctrine which has never been authorized by the Internal Revenue Code and has been severely limited by decisions of the Supreme Court and lower courts.

## CONCLUSION.

Appellant respectfully submits that the judgment of the District Court should be reversed and the judgment prayed for in its complaint should be granted.

Dated, San Francisco, California,
July 16, 1956.

Respectfully submitted,

W. T. Fitzgerald,
Clarence E. Musto,
Franklin C. Latcham,
Morrison, Foerster, Holloway,
Shuman & Clark,
*Attorneys for Appellant.*